Representation to Ministry of Finance – On issues faced by Private Equity / Venture Capital industry

7 January, 2015

PE/VC Industry has contributed to Indian economy across multiple dimensions

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- 200+ active fund managers operating in India
  - ~100 of which are domestic fund managers

- USD 80+ Bn investment in Indian companies by PE/VC over last 10 years, with relatively lower volatility in capital flow:
  - USD 7 - 10 Bn of yearly PE/VC investments in 300 – 400 transactions
  - PE/VC provided about 2x the capital raised from IPO in the last 5 years

- 2,800+ PE/VC invested companies; PE/VC backing typically drives culture of performance and discipline:
  - Higher top-line and bottom-line growth
  - Stronger corporate governance, tax compliance, lower loan defaults

- 12%+ employment growth in PE/VC invested companies vs ~3% in peer non-PE backed companies

PE is a more stable source of equity capital

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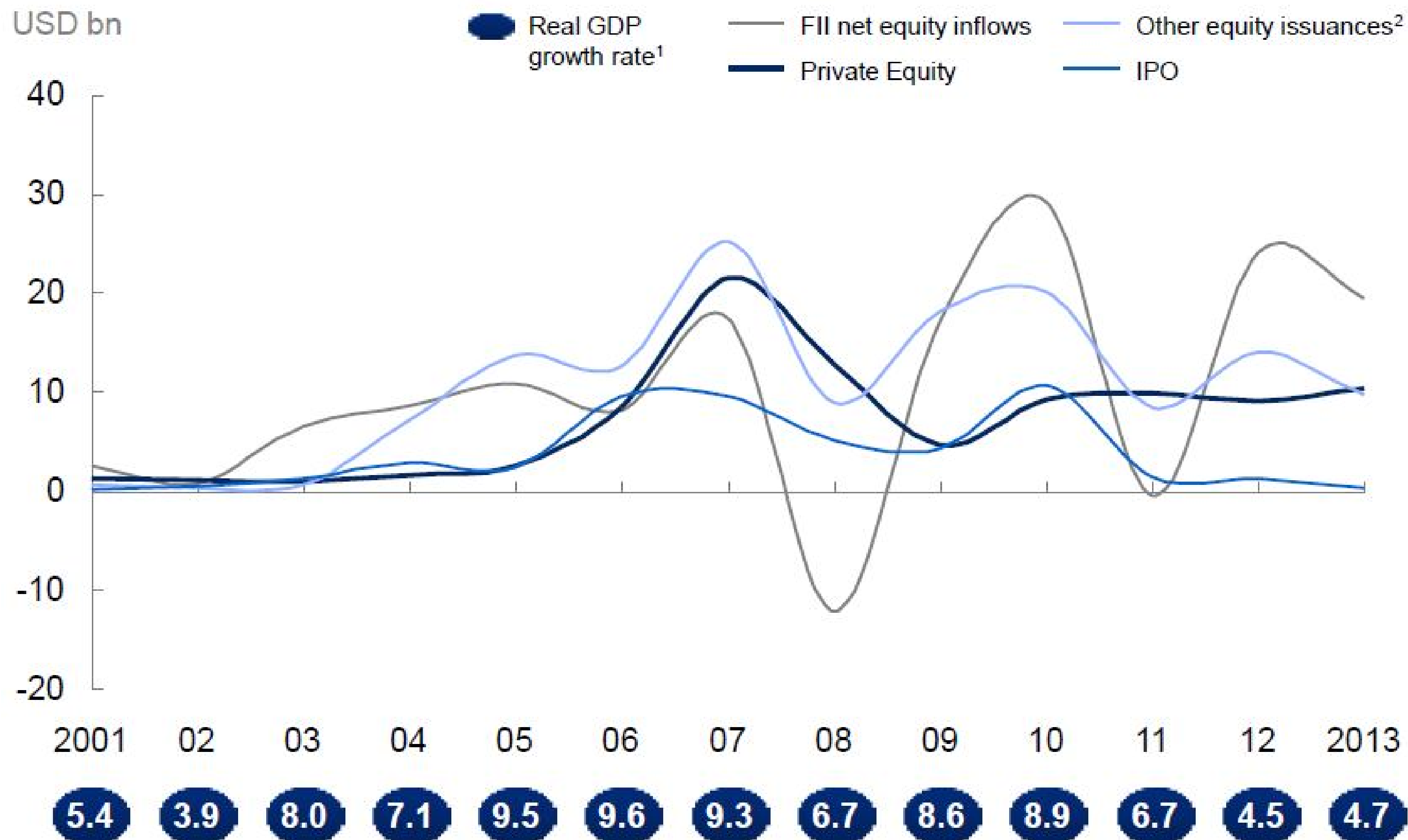
- PE/VC capital inflows has been relatively less volatile across economic cycles



1 Includes follow on offers, convertible bonds; 2 GDP growth rate at factor cost
SOURCE: SEBI; Central Statistics Office (MOSPI); Dealogic; AVCJ; VCCEdge; McKinsey analysis

PE-backed companies are creating employment at rapid pace

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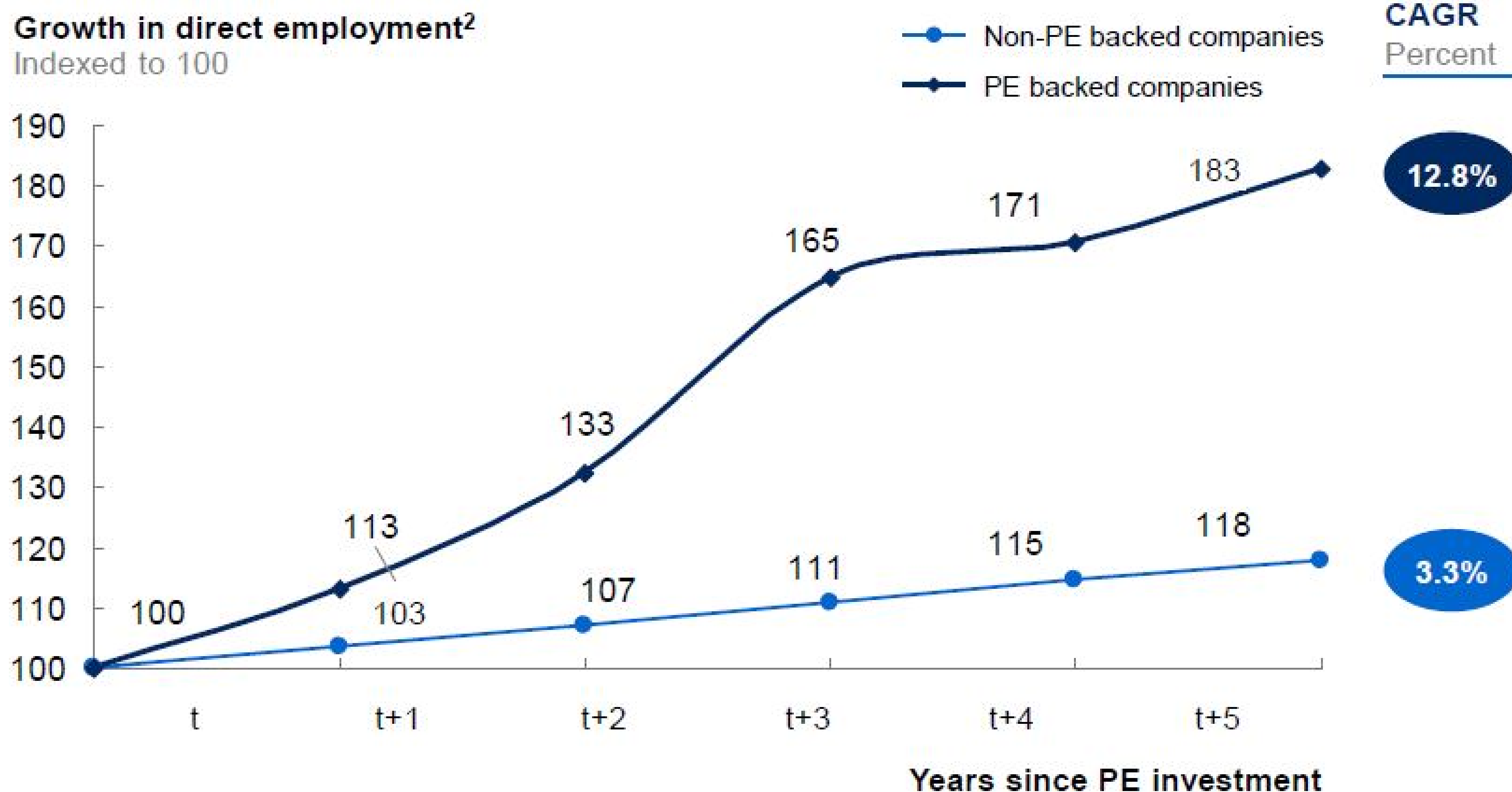
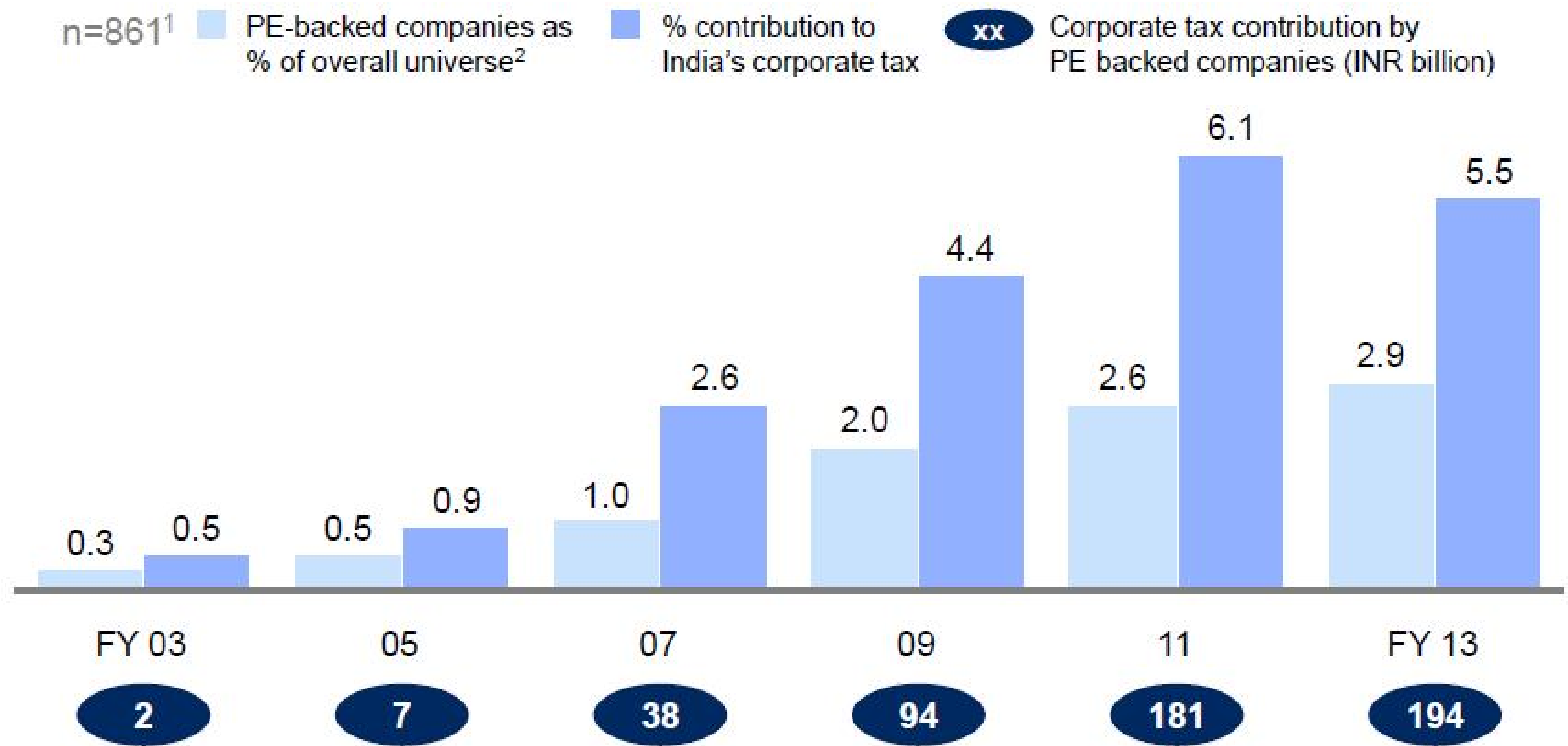
- PE-backed companies (sample of 85) saw employment increase at 12.5% (from 217,500 to 398,000) in 5 years compared to non-PE backed peers



1 PE backed sample consists of 85 companies that saw PE investments between 2003 and 2007 for whom data was available and found to be consistent; Non-PE backed sample of companies consists of 485 private sector companies
2 Using employment data from FY04 to FY 13
SOURCE: CMIE Prowess; AVCJ; VCCEdge; McKinsey analysis

PE-backed companies contribute a disproportionate share of direct taxes

- PE/VC backed companies, which form 2.9% of registered companies, contributed about double (5.5%) of India's total corporate tax in FY13



1 Sample of 861 PE-invested companies (~35% of PE backed company universe) and excludes companies with revenue > INR 750 crore
2 Universe of companies refers to 29,526 companies identified from CMIE Prowess, AVCJ, and VCCEdge
SOURCE: Department of Revenue (Ministry of Finance); CMIE Prowess; AVCJ; VCCEdge; McKinsey analysis

Recommendations to further boost PE/VC investments in India

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- **Part A: Domestic funds**
  - Provide tax 'pass through' to all categories of AIF*
  - Encourage insurance companies, EPFO, pension funds and charitable trusts to invest in AIFs*
- **Part B: Offshore funds**
  - GAAR
  - No 'permanent establishment' of offshore manager/ fund in India
  - Safe harbour for advisory entity in India
  - Tax rate on long term capital gains from transfer of shares of private limited companies
  - Indirect Transfer
- **Part C: Common to both Domestic and Offshore funds**
  - Holding period for unlisted shares
  - Tax on buyback of unlisted shares
  - Deemed characterisation of gains from investment as capital gains

* AIF – Alternative Investment Funds, as defined by SEBI AIF Regulations. PE and VC are types of AIFs.

Part A: Domestic funds

- Provide tax 'pass through' to all categories of AIF
- Encourage insurance companies, EPFO, pension funds and charitable trusts to invest in AIFs

Provide tax 'pass through' to all categories of AIFs

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Issue

- Currently, specific tax 'pass through' is applicable only to AIF Category I - VCF and erstwhile VCFs. Other AIFs are taxed as per trust taxation framework which is complex and has become more uncertain after the recent CBDT Circular No. 13 dated 28 July 2014
- Specific tax 'pass through' to AIF Category I-VCF and erstwhile VCFs is restricted to only VCU income i.e. non-VCU income is taxed as per trust taxation framework, creating dual point of tax compliance and complexity in tax administration

Rationale for change

- Tax 'pass through' does not result in any revenue loss; it merely shifts the point of taxation to investor thereby providing AIFs and their sponsors/ trustees much needed clarity
- Clarity of tax pass through should bring additional flows into the AIFs, which will directly contribute to growth in fees for managers of AIFs, resulting in additional tax collections
- Internationally tax 'pass through' is automatically available to collective investment vehicles - the recommendation will put India at par with the other countries

Recommendation

- Amend section 10 (23FB) of the Act to provide specific tax 'pass through' to income (including non-VCU income) earned by all categories of AIFs
- Alternatively, levy a withholding tax at 10% coupled with a tax pass through provision on any income distributed by the AIF to its shareholders

Encouraging insurance companies, EPFO, pension funds and charitable trusts to invest in AIFs

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Issue

- Globally insurance companies, pension funds and charitable trusts (including university endowments) are prominent investors in PE/ VC funds
- In India, while insurance companies invest in AIFs the proportion of investment is miniscule in comparison to the total corpus. Further, regulations governing pension funds and charitable trust do not permit investment in AIFs. As a result, large pool of capital remains unavailable for PE/VC investments in startups, SMEs and growing companies

Rationale for change

- Significant portion of investment corpus is invested in government paper which yield modest return -
  - Life and non-life insurers - Rs 18.68 lakh crores
  - EPFO - Rs 6.32 lakh crores
  - Charitable trusts - Rs 5 lakh crores
  - Pension funds - Rs 0.58 lakh crores

Recommendation

- PFRDA should permit investment in alternate asset class (AIF)
- Amend section 11(5) of the Act to permit charitable trusts to invest in AIFs
- Encourage insurance companies to invest in AIFs up to the exposure limit permitted by IRDA

Part B: Offshore funds

- GAAR
- No 'permanent establishment' of offshore manager/ fund in India
- Safe harbour for advisory entity in India
- Tax rate on long term capital gains from transfer of shares of private limited companies
- Indirect Transfers

GAAR

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Issue

- GAAR provisions have created significant uncertainty on whether offshore structures set up by PE funds for investing into India would be respected and treaty benefits granted, post 1 April 2015
- Investments made before 30 August 2010 have been grandfathered from GAAR, however, structures which may erstwhile have been considered legitimate may get impacted
- There is no clarity on whether GAAR will apply where SAAR is applicable

Rationale for change

- Substantive investments have been made into India from Mauritius and Singapore based on the effective assurance that, on exit, no tax would be levied in accordance with relevant DTAA and a valid TRC - no tax exemption on exits after 1 April 2015 results in an unfair treatment on the stakeholders
- Many countries do not apply GAAR where SAAR is applicable – it is a settled principle that, where a specific rule is available, a general rule does not apply

Recommendation

- GAAR should not apply to existing structures/arrangements which are legitimate as on 31 March 2015
- GAAR should not be invoked in cases where the offshore investment vehicle holds a valid TRC and satisfies the conditions of the relevant DTAA for tax exemption on capital gains
- GAAR should not be applied where SAAR is applicable
- Objective criteria for invocation of GAAR should be notified for greater certainty

No ‘permanent establishment’ of offshore manager/ fund in India

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Issue

- Fund managers of foreign investors (such as FPIs, FVCIs, etc.) remain outside India under the apprehension that their presence in India may have adverse tax consequences i.e. creation of a business connection / permanent establishment in India and offshore funds being regarded as tax resident in India
- An amendment was made in Finance Act (No. 2) 2014 to provide that income arising to FPIs from transaction in securities will be treated as capital gains. However, the provisions of the Act have not been adequately amended to address the aforesaid apprehension of the fund managers, resulting in a large number of offshore funds choosing to locate their investment manager outside India

Rationale for change

- By providing clarity on issues relating to business connection/ permanent establishment and residential status of offshore funds, India could benefit immensely since it would provide a sense of comfort to fund managers for choosing India as the base for investment managers

Recommendation

- Amend the Act (sections 6 and 9) to provide that management of offshore funds from India should not create a business connection/ permanent establishment of the offshore fund/ manager in India. Also, clarify that management of offshore funds in India would not result in the offshore fund being regarded as tax resident in India

Safe harbour for advisory entity in India

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Issue

- International transaction pertaining to advisory and support services provided by advisory entity in India to their overseas AEs is subject to transfer pricing
- Typically, advisory entity in India charge their AEs for such services on a cost-plus mark-up basis; the mark-up ranges from 15% to 25%
- Margin for such transaction assessed by the TPO currently varies from 35% to 106%

Rationale for change

- Upward adjustment to the margins by the TPOs lead to prolonged litigation
- Income-tax Tribunals have deleted adjustments made by the TPOs and have restored the margin charged by the advisory entity in India
- Certainty is required on the margin to be charged by the advisory entity in India to provide confidence to PE funds on the Indian tax system
- It is understood that the APA authority has accepted a margin of 21% for advisory and support services

Recommendation

- Safe harbour margins in the range of 20% to 25% could be prescribed for advisory and support services provided by advisory entity in India, under Rule 10TD of IT Rules

Tax rate on long term capital gains from transfer of shares of private limited companies

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Issue

- Section 112(1)(c) of the Act provides a concessional tax rate of 10% on long term capital gains earned from transfer of unlisted securities in the hands of the non-residents
- However, the manner in which the term 'unlisted securities' has been defined in the Act leads to the unintentional consequence of the 10% concessional tax rate not being applicable to long-term gains on transfer of shares of private limited companies

Rationale for change

- The intention of the legislature to amend section 112(1)(c) of the Act was to provide PE players a level playing field, similar to FPIs
- Given that a significant portion of investments by PE funds in India are in private limited companies, the recommendation will ensure that the intended beneficiaries actually benefit from the tax provisions

Recommendation

- Amend the definition of the term 'securities' in Explanation (a) to section 112(1) of the Act to include shares of private limited companies

Part C: Common to both Domestic and Offshore funds

- Holding period for unlisted shares
- Tax on buyback of unlisted shares
- Deemed characterisation of gains from investment as capital gains

Holding period for unlisted shares

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Issue

- The Finance Act (No. 2), 2014 amended (w.e.f. 11 July 2014) the period of holding for treating gains from unlisted shares as short-term capital gains from 'not more than 12 months' to 'not more than 36 months'
- Many investments are structured as CCPS/ CCDs for commercial considerations. In such cases, the conversion typically happens close to the 'Offer for Sale' or an IPO event. As a result of the aforesaid amendment, gains on sale of equity shares will be considered as short term capital gains, even when the CCPS/ CCDs have been held for more than 36 months

Rationale for change

- In case of equity shares received on conversion of CCPS/ CCDs, the cost of acquisition of equity shares is calculated with reference to the cost of acquisition of CCPS/ CCDs. Hence, for determining the holding period of equity shares, the period of holding CCPS/ CCDs should also be considered

Recommendation

- In the context of convertible securities, where conversion is not a taxable event, the period of holding of the equity shares should be considered from the date of acquisition of such convertible securities and not from the date of allotment of the equity shares-Amend definition of short term capital asset under section 2(42A) of the IT Act.

Tax on buyback of unlisted shares

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Issue

- The intention to introduce tax on buyback was to curb use of buyback for distributing profits and not paying DDT, however, it has unintentionally impacted genuine transactions
- Buyback tax rate is not aligned to the Dividend Distribution Tax (DDT) rate
- Buyback tax is also not linked to the distributable profits i.e. even if the company does not have distributable profits, it is required to pay tax on buyback of shares
- Possibility of disputes on the expression 'amount which was received by the company for issue of shares' in case of buyback of shares received on conversion of CCPS/ CCDs

Rationale for change

- The Expert Committee on GAAR had acknowledged that buy back of shares is a business choice of a company, which it is entitled to exercise at any point of time. It does not result in tax avoidance

Recommendation

- Given that buyback tax was introduced to curb avoidance of DDT, following amendment should be made in s.115QA of the IT Act :-buyback tax rate should be aligned to the DDT rate
  - buyback tax should be linked to the distributable profits of the company
- Amend s.115O for corresponding relief in DDT calculation when dividend is actually distributed out of reserves
- Clarify the expression 'amount which was received by the company for issue of shares' to also mean -
  - Issue price of convertible securities, in case of buyback of shares received on conversion

Deemed characterisation of gains from investment as capital gains

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Issue

- Characterisation of income from sale of securities as business income or capital gains has always been a vexed issue with no objective criteria. The only guiding principles are past CBDT instructions and Circular which in majority of cases are not applied by the tax authorities
- Given that investment by AIFs/ VCFs/ FVCIs are typically made with a medium to long-term view, deemed characterisation of gains from such investments as capital gains would help in achieving certainty

Rationale for change

- The Finance Act (No. 2), 2014 has amended the definition of capital asset under section 2(14) of the Act to include securities held by FPIs (notwithstanding the individual trading patterns / investment strategy)
- Given the medium to long term holding period of investments made by AIF/ VCF/ FVCI, these investors should stand ahead of FPIs to be beneficiary of this clarification
- It will provide much needed clarity and mitigate avoidable litigation with the tax authorities

Recommendation

- Amend the definition of capital asset under section 2(14) of the Act to include investments held by AIFs/ VCFs/ FVCIs

Glossary

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Act	The Income-tax Act, 1961
AEs	Associated Enterprises
AIF	Alternative Investment Fund
CCDs	Compulsorily Convertible Debentures
CCPS	Compulsorily Convertible Preference Shares
CBDT	Central Board of Direct Taxes
DDT	Dividend Distribution Tax
DTAA	Double Taxation Avoidance Agreement
EPFO	Employees Provident Fund Organisation
FPI	Foreign Portfolio Investor
FVCI	Foreign Venture Capital Investor

GAAR	General Anti-Avoidance Rule
IPO	Initial Public Offer
IRDA	Insurance Regulatory and Development Authority
PE	Private equity
PFRDA	Pension Fund Regulatory and Development Authority
SAAR	Special Anti-Avoidance Rule
TPO	Transfer Pricing Officer
TRC	Tax Residency Certificate
VC	Venture Capital
VCF	Venture Capital Fund
VCU	Venture Capital Undertaking

Clarification on 'Indirect Transfer'

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Issue

- Explanation 5 to section 9(1) of the Act states that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India. Consequently, transfer of such asset (being share or interest in a company or entity outside India) is deemed to be income accruing or arising in India

- The absence of an objective criterion to evaluate whether or not an overseas asset is deemed to be located in India so as to trigger indirect transfer and the definition of the term 'substantially' leads to significant subjectivity, uncertainty and litigation.

- A literal interpretation of the wordings of Explanation 5 to section 9(1) of the Act, *inter-alia,* results in potential India tax liability in following cases –
  - The phrase 'the share or interest in a company or entity registered or incorporated outside India' includes even small shareholders whose shareholding may not result change in ownership, capital, control or management of the Indian company. In other words, even if a single share of a foreign company having substantial assets in India is transferred outside India, then the gains arising on such a transfer would be taxable in India
  - Transfer of shares in a foreign company (listed on a stock exchange outside India) having substantial assets located in India

Clarification on 'Indirect Transfer'

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Suggested change

Make suitable amendments in section 9 of the Act to provide following:

- Define the word 'substantially' to mean a threshold of at least 50% of the total value being derived from assets in India
- Provide exemption from indirect transfer provisions to small/ minority shareholders (holding up to 26%) in a foreign company deriving substantial value from assets located in India
- Provide exemption from indirect transfer provisions to transfer of shares of a listed foreign company deriving substantial value from assets located in India. Many countries do not apply GAAR where SAAR is applicable – it is a settled principle that, where a specific rule is available, a general rule does not apply

Rationale for change

- The aforesaid suggestions are in line with the provisions in the Draft Direct Tax Code 2010 and recommendations of the Dr Shome Committee on Indirect Transfers
- Defining 'substantially' to mean a threshold of at least 50% of the total value being derived from assets in India is also supported by the Delhi High Court ruling in the case of Copal Research Limited, Mauritius [WP (C) 2470/2013]